

The Role of Efficiencies in Integrated Merger Analysis

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WHAT KINDS OF EFFICIENCIES ARE RECOGNIZED BY THE GUIDELINES?

- The Guidelines state that “certain types of efficiencies are more likely to be cognizable and substantial than others.”
 - Production Efficiencies are thought to be “cognizable and substantial”
 - Innovative Efficiencies are thought to be “substantial,” but less verifiable
 - Procurement, Management, and Capital Cost Efficiencies are thought to be less likely to be merger-specific or substantial.

WHAT KINDS OF EFFICIENCIES SHOULD BE RECOGNIZED?

- Although the agencies have more experience dealing with certain types of efficiencies, other types of efficiencies should not be excluded or handicapped on a generic basis.
- Perhaps reflecting the thinking of the past 13 years, the new EU Guidelines clarify that the Commission “considers any substantiated efficiency claim in the overall assessment of the merger.”

WHAT KINDS OF EFFICIENCIES SHOULD BE RECOGNIZED?

1. Productive Efficiencies – least controversial

- Economies of Scale
- Economies of Scope
- Synergies

- ⇒ Variable costs are the least controversial category of costs.
- ⇒ Reductions in fixed costs are more controversial, even though they can lead to both lower prices and other significant non-price benefits for consumers.
- ⇒ The agencies should focus less on the distinction between variable and fixed cost efficiencies and begin with a presumption that both will be passed on to consumers.

WHAT KINDS OF EFFICIENCIES SHOULD BE RECOGNIZED?

2. Distribution and Promotional Efficiencies

- *1997 Revisions* silent. The FTC Global Staff Report views these types of efficiencies as “*less likely to be substantial and often likely to be difficult to assess.*”
- FTC Chairman Muris noted that “*in the cost structure of consumer goods, promotion plays an important role, particularly since the larger market share may be needed to achieve minimum efficient scale*” and suggested that the government should recognize this type of efficiency.

⇒ **Distribution and promotional efficiencies can be significant, with the Agencies having considered them when contemplating divestiture remedies (e.g. Nestle/Dryers, Exxon/Mobil, General Mills/Pillsbury).**

WHAT KINDS OF EFFICIENCIES SHOULD BE RECOGNIZED?

3. Dynamic or Innovative Efficiencies

- *1997 Revisions* — efficiency claims “relating to research and development are potentially substantial but are generally less susceptible to verification and may be the result of anticompetitive output reductions.”
- *FTC Global Report* acknowledged that “innovation efficiencies may make a particularly powerful contribution to competitive dynamics, the national R&D effort, and consumer (and overall) welfare.”

⇒ **Dynamic and Innovative efficiencies offer great potential but, because they tend to focus on future products, they are more difficult to quantify and to prove. However, to the extent that they are verifiable, the Agencies should consider them in integrated merger analysis.**

WHAT KINDS OF EFFICIENCIES SHOULD BE RECOGNIZED?

4. Transactional Efficiencies

- Eliminates the “middle man” and “double marginalization.”
- U.S. antitrust law is not always sensitive to the role of mergers in reducing these costs.

⇒ **Transactional efficiencies are real and the Agencies should consider them in integrated merger analysis.**

WHAT KINDS OF EFFICIENCIES SHOULD BE RECOGNIZED?

5. Procurement, Management, and Capital Cost Savings

- *1997 Revisions* — deemed less likely to be merger-specific or substantial, or may not be cognizable for other reasons.
- ***Procurement Savings*** — reduced number of suppliers or the streamlining of the buying process can reduce the costs, which are typically considered in integrated merger analysis.
- ***Managerial Savings*** — discounted as not being merger-specific and a fixed cost less likely to be passed on to consumers in the short term, but are real and should be considered.
- ***Capital Cost Savings*** — are disfavored because of their relatively fixed nature even though they can dramatically improve a firm's cost position and competitiveness. The Agencies should consider such savings.

⇒ **Procurement, Management, and Capital Cost efficiencies are real and should be considered in integrated merger analysis.**

WHAT BURDEN OF PROOF IS REQUIRED BY THE GUIDELINES AND CASELAW?

- “Efficiency claims will not be considered if they are vague or speculative or otherwise cannot be verified by reasonable means.”
- “The greater the potential adverse competitive effect of a merger . . . the greater must be cognizable efficiencies in order for the Agency to conclude that the merger will not have an anticompetitive effect in the relevant market.” [Merger Guidelines, §4]
- Caselaw suggests that high market concentration levels require proof of "extraordinary" efficiencies. (*FTC v. H.J. Heinz Co.*)
- Consider also the new EU guidelines which state that to be considered by the Commission, efficiencies must be substantial enough to counteract a merger's potential harm to consumers and must “be merger-specific, and be verifiable.”

HOW DOES THE BURDEN OF PROOF CHANGE AS THE CONCENTRATION LEVEL INCREASES?

- Caselaw requires the government to show anticompetitive effects and then allows the parties to present pro-competitive justifications (including efficiencies) that might outweigh this potential harm.
 - Consider Section 1 cases which require the government to present a *prima facie* case and then allow the parties to introduce mitigating factors (e.g. efficiencies) under a rule or reason test. (*NCAA*)
- The Guidelines assert that “market concentration is a useful indicator of the likely potential competitive effect of a merger,” but do not advocate a *per se* rule.
 - But see (1) the presumptions created by the safe harbors; and (2) language suggesting that efficiencies almost never justify a merger to monopoly or near-monopoly.
- There is no caselaw suggesting that *per se* rules based on market concentration are appropriate in merger analysis.

HOW DOES THE BURDEN OF PROOF CHANGE AS THE CONCENTRATION LEVEL INCREASES?

In light of the debate about the relationship between concentration levels and competitive effects, it is inappropriate to create a *per se* rule. A presumption of anticompetitive effects from high concentration levels should be subject to rebuttal by proof of pro-competitive efficiencies. Demonstration of such efficiencies should shift the burden back to the plaintiff.

BURDEN OF PROOF: EFFICIENCIES vs. ANTICOMPETITIVE EFFECTS

- Efficiencies should be subject to the same standards of proof as evidence relating to the likelihood of anticompetitive effects, particularly careful efficiencies studies based on third-party data.
- Clayton Section 7 allows “probabilities,” but not “ephemeral possibilities,” and that standard also should be applied in determining the validity of an efficiency claim.

BURDEN OF PROOF: AGENCY DECISIONS vs. COURT PROCEEDINGS

- The burden of proof used by the court in a trial should be the same as the burden of proof used by the agency in deciding whether to challenge a merger.
 - “The United States Attorney is the representative not of an ordinary party to a controversy, but of a sovereignty whose obligation to govern impartially is as compelling as its obligation to govern at all; and whose interest, therefore, in a criminal prosecution is not that it shall win a case, but that justice shall be done.” (*Berger v. United States*)
- To build in presumptions against efficiencies tilts the playing field and increases the likelihood of Type I errors.

WEIGHING EFFICIENCY EFFECTS IN DECLINING INDUSTRIES

- When reviewing a merger in a failing industry (e.g., one in which the price is lower than the average total cost), the Agencies should pay careful attention to potential dynamic or innovative efficiencies.
- The integrated merger analysis should give efficiencies more weight if the profitability of a failing industry can be improved by the merger (e.g., by lowering fixed costs) even if the price effects are not immediate.

WEIGHING EFFICIENCY EFFECTS IN DECLINING INDUSTRIES

The Guidelines can be read to support a “failing industry” defense:

- Changing Market Conditions: the agency will consider “recent or ongoing changes in the market,” which might include all firms in a declining industry. [Merger Guidelines, §1.521]
- Efficiencies needed to remain competitive: “merger-generated efficiencies may enhance competition by permitting two ineffective (e.g., high cost) competitors to become one effective (e.g., lower cost) competitor.” This defense might apply to all firms in a failing industry. [Merger Guidelines, §4]
- Failing Firm defense: “if imminent failure . . . of one of the merging firms would cause the assets of that firm to exit the relevant market.” This defense might apply to all firms in a failing industry. [Merger Guidelines, §5]

CONCLUSIONS

- 1) The Guidelines should clarify that the competition authorities will consider all types of efficiencies as long as they are verifiable, substantial, and likely to be realized.
- 2) Efficiencies should be subject to the same standards of proof as evidence relating to the likelihood of anticompetitive effects both during agency review and in a court challenge.
- 3) When considering a merger in a failing industry, the Agencies should give more weight to potential dynamic or innovative efficiencies that could sustain the industry.